SUPREME COURT, U. S.

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In the

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1970

No. 1294

K. E. and Z. M. McAFEE, Husband and Wife; JOHN W. and MARY D. NICHOLS, Husband and Wife, WILLIAM N. and HELEN K. LITTLE, Husband and Wife; LOUIS R. and INEZ P. WILSON, Husband and Wife; JOE F. and MARION G. GIBSON, Husband and Wife; and W. M. and MARY E. AVERY, Husband and Wife,

Petitioners,

VERSUS

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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February, 1971

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In the
Supreme Court of the United States
OCTOBER TERM, 1970

No. ----------

K. E. and Z. M. McAFEE, Husband and Wife; JOHN W. and MARY D. NICHOLS, Husband and Wife, WILLIAM N. and HELEN K. LITTLE, Husband and Wife; LOUIS R. and INEZ P. WILSON, Husband and Wife; JOE F. and MARION G. GIBSON, Husband and Wife; and W. M. and MARY E. AVERY, Husband and Wife,

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The petitioners, K. E. and Z. M. McAfee, Husband and Wife; John W. and Mary D. Nichols, Husband and Wife; William N. and Helen K. Little, Husband and Wife; Louis R. and Inez P. Wilson, Husband and Wife; Joe F. and Marion G. Gibson, Husband and Wife; and W. M. and Mary E. Avery, Husband and Wife; pray that a Writ of Certiorari issue to review the opinion and judgment of the United States Court of Appeals, Tenth Circuit rendered in these proceedings on October 5, 1970.

OPINIONS BELOW

The opinion of the United States Court of Appeals, Tenth Circuit, as yet unreported, appears at Appendix A, *infra*, pp. i-v, and it reversed the opinion of the United States District Court for the Western District of Oklahoma which is unreported and appears at Appendix B, *infra*, pp. v-ix.

JURISDICTION

The judgment of the United States Court of Appeals, Tenth Circuit, was entered on October 5, 1970. See Appendix A, p. v, *infra*. Upon application of Petitioners, the Supreme Court granted an order dated January 4, 1971, extending the time within which to petition for certiorari to February 2, 1971. This petition for certiorari was filed within the time granted by the aforesaid Supreme Court Order. The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

ISSUE PRESENTED

The issue presented in this lawsuit pertains to the question of what constitutes an "economic interest" in oil, gas and other minerals. The Supreme Court has defined "economic interest" in *Palmer* v. *Bender*, 287 U.S. 551 (1933), as an interest which results when a taxpayer has acquired, by any form of legal relationship, a right to share in the income derived from the extraction of the mineral, but the Tenth Circuit has erroneously applied the concept in this case. The Tenth Circuit opinion, which reversed the opinion of the United States District Court below, is (i) in

conflict with the Supreme Court's opinion in *Helvering* v. *Elbe Oil Land Development Company, Ltd.*, 303 U.S. 372 (1938), and (ii) in conflict with the 8th Circuit's opinion in *Commissioner* v. *Remer*, 260 F.2d 337 (8th Cir., 1958).

STATUTES AND REGULATIONS INVOLVED

Section 611(a) of the Internal Revenue Code of 1954 provides as follows:

> "GENERAL RULE.—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate. For purposes of this part, the term 'mines' includes deposits of waste or residue, the extraction of ores or minerals from which is treated as mining under section 613(c). In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this section for subsequent taxable years shall be based on such revised estimate."

Treasury Regulation Section 1.611-1(b)(1) provides as follows:

> "(b) ECONOMIC INTEREST. (1) Annual depletion deductions are allowed only to the owner of an economic interest in mineral deposits or standing timber. An economic interest is possessed in every case in which the taxpayer has acquired by investment any

interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because through a contractual relation he possesses a mere economic or pecuniary advantage derived from production. For example, an agreement between the owner of an economic interest and another entitling the latter to purchase or process the product upon production or entitling the latter to compensation for extraction or cutting does not convey a depletable economic interest. Further, depletion deductions with respect to an economic interest of a corporation are allowed to the corporation and not to its shareholders."

STATEMENT OF THE CASE

At one time and in a single transaction occurring on January 18, 1961, Petitioners sold and assigned all their right, title and interest in certain producing oil and gas leases and related equipment to Island Oil Company (Island Oil) and The Second Tarrant Foundation (Second Tarrant) for $500,000 cash, which was paid at the closing, plus a deferred additional consideration, secured by a vendor's lien on leasehold equipment and personal property sold, payable if and after the purchasers had recovered $500,000 plus interests and operating expenses, equivalent to $1.25 per barrel of oil thereafter produced, saved and sold from the properties covered by the assigned leases not to exceed in the aggregate $200,000. If the market value of oil, less taxes, decreased below $1.25 per barrel, the Buyer

(Island Oil) was required to liquidate its $200,000 obligation owed Petitioners at a rate equal to the lesser per barrel equivalent.

The transaction was consummated at a single closing attended by all parties or their representatives at which the following instruments were dated, executed and delivered:

1. An assignment to Island Oil under which Island Oil acquired all rights in the leases except a production payment which was being contemporaneously sold to Second Tarrant. The Assignment also granted the Petitioners a Vendor's Lien, not on production, but on the assigned leasehold and equipment to secure the deferred and contingent portion of the purchase price.

2. A separate instrument of assignment under which Petitioners sold and assigned to Second Tarrant the production payment excepted from the Assignment to Island Oil which consisted of the right to receive 80 per cent of 3/4ths of the production from the leased properties until the sum of $320,000 plus a factor equivalent to interest had been recovered by the assignee.

The record reflects that Petitioners negotiated the entire transaction with Island Oil and the decision that the property would be jointly acquired was the decision of Island Oil and not that of Petitioners. Even though two purchasers were ultimately involved, Petitioners intended to make only one sale. The record further reflects that during the negotiation, Petitioners had engineering data on the properties indicating sufficient reserves to meet the conditions precedent to purchasers' obligation to pay the

additional $200,000 contingent portion of the purchase price. This subsequently proved to be the case as Petitioners have received all consideration that they bargained for in the sale.

Petitioners, in their Federal income tax returns for 1961, treated the difference between their basis in the property sold and the $500,000 cash received at closing as capital gain. The Commissioner of Internal Revenue assessed additional income taxes against Petitioners for 1961 by treating $320,000, the portion of the purchase price paid by Second Tarrant for the production payment as ordinary income (subject to depletion) rather than as capital gain. Petitioners paid the additional taxes assessed by reason of such treatment and sued for refund.

The United States District Court for the Western District of Oklahoma, which had jurisdiction of the case pursuant to 28 U.S.C. §1346(a)(1), held for Petitioners whereupon the Government appealed to the United States Court of Appeals for the Tenth Circuit which reversed the District Court and held for the Government.

Prior to the Tax Reform Act of 1969, a widely publicized and used method of financing oil and gas sales was the ABC transaction. This may be described as a situation where A sells an oil and gas lease to B, reserving a production payment which is then sold to C. A has divested himself of the entire lease and gets capital gain on both sales.

The facts of this case illustrate a typical ABC transaction, and the tax consequences to the parties would not have resulted in controversy but for the $200,000 deferred

payment portion of the purchase price bargained for by Petitioners. Petitioners contend that the sale to Island Oil and Second Tarrant divested them of all their interest in the leases and therefore, Petitioners are entitled to capital gain on both sales. The Government contends Petitioners reserved two production payments in series (a $320,000 production payment plus an additional $200,000 production payment after the first production payment has paid out) and that a sale of the $320,000 production payment was a "carve out" resulting in ordinary income.

Leland E. Fiske, in his book *Federal Taxation of Oil and Gas Transactions,* describes and adequately supports the basic principles pertaining to the taxation of production payments, including the distinction between the sale of a production payment and the sale of a carved-out production payment. A restatement from this book would seems helpful in understanding this case:

> "The sale of an oil payment 'carved out' of a working interest, a royalty, or a larger oil payment, and not pledged for development, has long been held by the Internal Revenue Service to result in ordinary income, subject to depletion and to be equivalent to an advance sale of oil. The correctness of this position was at one time placed in doubt by a number of court decisions, but the position of the Internal Revenue Service has been finally approved by the Supreme Court . . .
>
> "If the sale of the oil payment divests the seller of all interest in the property, capital gain will be recognized. Thus A, owning an oil lease, may sell the working interest to B, retaining an oil payment, and then sell the oil payment to C. A has divested himself of the entire lease and gets capital gain on both sales. A

might also sell part of his retained oil payment for its full life and gets capital gain, as this would not be a carved out interest. It has been held that where a property is sold with two oil payments retained, running concurrently, one oil payment can be sold and the gain reported as capital gain. But in a similar situation where the two retained oil payments ran in series, with the start of the second deferred until payout of the first, a sale of the first was held to constitute a sale of a carved out oil payment with proceeds taxable as ordinary income. The same decision has been reached where a property was transferred, with a royalty and an oil payment retained, and then the oil payment was sold; the sale was held to be of a carved out oil payment. Any sale of an oil payment, except a sale of a carved out oil payment running for a period shorter than the life of the interest from which carved, will be recognized by the Internal Revenue Service as giving rise to capital gain under Section 1231 of the 1954 Internal Revenue Code . . ." pp. 133-136.

If, as the Court of Appeals held, Petitioners retained and then sold in a separate transaction an economic interest in the oil and gas that might be produced under the leases sold to Island Oil in the form of a $200,000 production payment, Petitioners concede that the sale to Second Tarrant falls squarely within the rationale set forth by the Supreme Court in *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260 (1958), and that Petitioners realized ordinary income from the sale. However, the *Lake* case applies solely to sales of "carved out" production payments and would not apply to the sale of an oil and gas lease which divests the holder of all interest in the property.

Accordingly, the specific question at issue is whether the Petitioners' right to the additional $200,000 from Island Oil is an "economic interest" in the oil and gas that may be produced under the assigned leases so as to make the right a "production payment."

REASONS FOR GRANTING WRIT

1. THE DECISION OF THE COURT OF APPEALS IS IN CONFLICT WITH THE SUPREME COURT'S DECISION IN HELVERING v. ELBE OIL LAND DEVELOPMENT COMPANY, LTD., 303 U.S. 372 (1938)

The Supreme Court, in the *Elbe* case, clearly held that where the assignor assigns all of his right, title and interest in the property and the assignee agrees to make additional payments in the future after payout, the assignor does not retain an economic interest even though the future payments are measured by net profits. The critical language of the *Elbe* assignment was as follows:

> "Anything in this agreement contained to the contrary notwithstanding, it is the intention of the parties to this agreement that the full ownership, possession and control of all the property . . . shall be vested in Honolulu, and Elbe shall have no interest in or to said properties . . ." (303 U.S. at 374).

The contract under consideration in *Elbe* provided for an initial cash payment, installment payments and a monthly payment of one-third of the net profits resulting from production. The transferee was not required to develop the property. The Court held that the provision for the additional payment from net profits did not in any way change the fact that the transaction was an absolute sale,

and that the provision for the additional payment was nothing more than a personal covenant on the part of the purchaser. The Court concluded that the assignor had disposed of all the properties and retained no interest or investment therein stating:

> "We agree with the conclusion of the Board of Tax Appeals that the contract between the respondent and the Honolulu Company provided for an absolute sale of all the properties in question, including all the oil and gas in place, and that respondent did not retain any interest or investment therein. The aggregate sum of $2,000,000 was paid as an agreed purchase price to which was to be added the one-third of the net profits payable on the conditions specified. We are unable to conclude that the provision for this additional payment qualified in any way the effect of the transaction as an absolute sale or was other than a personal covenant of the Honolulu Company." (303 U.S. at 375).

Thus, *Elbe* supports the proposition that neither the retention of the right to installment payments nor of the net profits interest was sufficient to change what the parties expressly intended to be a sale into a sublease. As an absolute sale, the payments were income received from the sale of a capital asset.

In comparison to *Elbe*, Petitioners' assignment to Island Oil recited:

> "It is the intention of the Assignors to sell, assign, grant and convey and Assignors hereby sell, assign, grant and convey to Assignee, its successors and assigns, all of Assignor's right, title and interest in the oil, gas and other minerals in, under or that may be produced from the above described land, excepting

only the production payment described in paragraph 2 . . ." (Note: pertaining to the $320,000 production payment assigned to Second Tarrant).

In consideration of the interest assigned to Island Oil, Petitioners received a cash down payment of $180,000 plus a right to a deferred additional consideration, secured by a vendor's lien on leasehold equipment and personal property sold, payable if and after the assignees had recovered $500,000 plus interest and operating expenses, equivalent to $1.25 per barrel of oil thereafter produced, saved and sold from the properties covered by the leases not to exceed in the aggregate the amount of $200,000. Petitioners had engineering data on the properties indicating sufficient reserves to meet the conditions precedent to purchaser's obligation to pay the additional $200,000 portion of the purchase price. There was never any doubt by the parties that the deferred consideration would be paid and subsequent facts proved this correct.

Petitioners' assignment to Island Oil was practically identical to the assignment passed on by the Supreme Court in *Elbe*. All *indicia* of a sale were present. When all of the terms of the instruments of assignment are taken into account, it is clear that Petitioners intended to assign and did assign all of their interest in the minerals, retaining no economic interest or right whatsoever save only the "vendor's lien to secure payments to be made if the same became payable . . ." of the $200,000 additional payments bargained for. Petitioners' rights after the sale amounted to nothing more than a contract right under a covenant by the assignee to pay money. The purchaser's obligation was personal and was limited to $200,000 without regard to

the economies of the oil and gas business during the payout period. The rate of payment was controlled by a fixed amount per barrel of oil produced. Gross production only served as a measure to set the time of payment by Island Oil pursuant to the contractual obligation. Further, the obligation was secured by a vendor's lien on the leasehold and equipment and could be satisfied from sources other than production. Consistent with *Elbe*, Island Oil was under no obligation to develop the property. Finally, the pipelines and other purchasers of the production recognized that Petitioners had not retained any economic interest in the property. After the date of sale, all payments for production were made to the assignees who, in turn, made payments to Petitioners as and when they became payable.

After referring to its earlier decisions in *United States* v. *White*, 401 F.2d 610 (10th Cir. 1968), and *Commissioner* v. *Pickard*, 401 F.2d 615 (10th Cir. 1968), the Court of Appeals below stated:

> "No purpose would be served by retracing our steps. We had recognized the retained economic interest rule and held that *Helvering* v. *Elbe Oil Land Development Company*, upon which the taxpayers rely, is limited to its particular facts."

Therefore, it is necessary to refer to the *White* and *Pickard* decisions to determine the reason that the Court of Appeals rejected the principles of the *Elbe* case.

In *White*, the taxpayer conveyed in the form of a mineral deed all minerals in place for a cash consideration of $175,000. He retained a 10 per cent royalty interest. The grantee was not required to develop the property. The

Court of Appeals overruled its prior decision in the same case and held that the entire transaction constituted a lease rather than a sale. In the previous case, the Court of Appeals had held that the royalty reservation was no more than a deferred payment provision that was additional consideration over and above the lump sum payment made at the time of execution of the deed. Considering the relevance of *Elbe* and refusing to follow it, the Court of Appeals stated:

> "In the *Elbe* case, an assignment of an oil and gas lease was made for a lump sum payment followed by fixed installments together with a net profit interest. The question concerned depletion on the lump sum and the installments. The Supreme Court held this to be a sale. The Court apparently relied on recitations in the assignment of the oil and gas lease to the effect that the parties intended the '. . . *full ownership, possession and control of all the properties, . . . shall be vested in (the buyer) and (the seller) shall have no interest in or to said properties . . .*' " (Emphasis ours.) (401 F.2d at 613).

The Court of Appeals in *White* went further and said:

> "Other Courts have relied upon the language of *Elbe,* and the *Burton-Sutton* distinction in opinions concerned with hard mineral cases, and have held that a sale has taken place although the seller may have kept some sort of deferred payment. In view of the treatment of the *Elbe* case by the Supreme Court in subsequent cases we do not consider it as authority for a position contrary to the one we here take." (401 F.2d at 613).

The Tenth Circuit reached a similar result in *Pickard.* It held that the transferor of an oil and gas lease had re-

tained an economic interest in the form of a 5 per cent royalty and that the transaction was a lease rather than a sale. It stated:

> ". . . the Tax Court in its consideration of the facts placed much emphasis upon the absence of any undertaking by Pan American to develop the properties. The Tax Court cites *Elbe* that this absence of such an obligation indicates that an outright sale took place. We do not construe *Elbe* as so holding." (401 F.2d at 616).

Subsequent Supreme Court decisions have distinguished but not rejected the principles set forth in *Elbe*. The Supreme Court in *Burton-Sutton Oil Company, Inc.* v. *Commissioner*, 328 U.S. 25 (1946), distinguished the *Elbe* case on the basis that after the transfer in the latter case the assignor was to have "no interest in or to said properties." (328 U.S. at 36). The Court noted that the provision in the contract in the *Elbe* case for the transfer of all of the interest of the assignor was a significant part of the agreement and resulted in the Court concluding that a sale had occurred. The assignment in the *Burton-Sutton* case "required the grantee to drill promptly, to account for production, to pay over 50% of the receipts less agreed costs and expenses and to sell the production on defined terms to the grantor, if grantor desired to purchase." (328 U.S. at 36-37). The Court recognized that distinction stating "The last clause did not appear in the *Elbe* contract. Such a transfer of rights to exploit could not, we think, properly be construed as a sale. It is rather an assignment to the operator, petitioner here, of the right to exploit the property with a reservation in the assignor of an economic interest in the oil." (328 U.S. at 37).

The Supreme Court decisions in *Elbe* and *Burton-Sutton* leave little doubt that two important tests must be applied in determining whether a transaction is a sale or sublease: (1) intent of the parties, and (2) retention of control, as evidenced by the presence or absence of an obligation to produce and develop by the transferee. The importance of the development obligation is explained by Leland E. Fiske:

> "Just as a royalty retention is evidence of a lease, so a lack of development obligation is evidence of a sale. The courts have held that even though a royalty is retained, the transaction might still be a sale if the parties intended a sale. Great weight will be given to the intent of the parties. Lack of requirement for development is strong evidence that a sale was intended." 13 *Oil & Gas Tax Quarterly* 164 (Spring, 1964).

In refusing to conclude that Petitioners' conveyance to Island Oil divested them of all interest in the property, the Court of Appeals rejected the principles of the *Elbe* decision and its progeny. The parties definitely intended a sale and Island Oil was under no obligation to develop or produce the property. Thus, it is clear that the decision of the Court of Appeals is in direct conflict with the decision of the Supreme Court in *Elbe*.

2. THE DECISION OF THE COURT OF APPEALS IS IN CONFLICT WITH THE COURT OF APPEALS FOR THE EIGHTH CIRCUIT'S DECISION IN COMMISSIONER v. REMER, 260 F.2d 337 (8th Cir. 1958)

In *Remer*, taxpayer sold and assigned all rights in his iron ore leases in consideration of payments of $100,000 in 1947, $50,000 in 1948 and $50,000 in 1949 plus the sum of $.10 per ton for concentrates shipped from the properties. The issue was whether a deferred payment arrangement measured by production constituted an economic interest in the property sold that would convert the transaction to a lease rather than a sale. The Court of Appeals held that taxpayer had not retained an economic interest and that he was entitled to capital gain on the lump sum payments as well as the payments measured by production.

Relying on the Supreme Court's decision in *Elbe*, the Court of Appeals in *Remer* stated that:

> "The written assignments were in the language of an absolute sale under warranty of title and contained no provision retaining any interest in the property so sold. The provision in the assignments for the payment of $.10 per ton on such concentrates as might be shipped imposed no obligation on the transferee to ship any ore, and the transferor retained no interest in the ore in place. The consideration to be paid was definite and absolute and the provision with reference to paying $.10 per ton for the ore shipped was simply a method of measuring the added consideration to be paid. The transferor had the bare right to payments measured by production. This did not, we think, result in the transferor retaining an economic interest in the

property sold. It was merely a covenant on behalf of the transferee to pay additional consideration to the transferor." (260 F.2d at 339).

The Court of Appeals below recognized that its opinion conflicted with the Eighth Circuit's opinion in *Remer* stating:

> "We noted *Commissioner of Internal Revenue* v. *Remer,* cited by the taxpayers, and *declined to follow it.*" (Emphasis ours.)

After rejecting *Remer,* the Court of Appeals in *White* attempted to distinguish *Remer* in the following language:

> "These cases are primarily concerned with minerals other than oil and gas, and are cases in which the doctrines developed in the oil and gas cases concerning assignments with retained interests are not followed. In these cases the Courts, in departing from the oil and gas authorities, have held the 'intent' of the parties leads to a sale conclusion, or that the 'dominant purpose' of the transaction, or the 'true substance' of the assignments leads to such a departure. *Also, these cases include instances where the 'royalty' payment is on a unit basis unrelated to value of the substance to be removed.*" (Emphasis ours.) (401 F.2d at 612).

We have emphasized the language of the Tenth Circuit to the effect that *Remer* and similar cases include instances where a royalty payment is on a unit basis unrelated to value of the substance removed. If such a factor is an *indicia* of sale, as the Tenth Circuit implies, we would point out that the $1.25 per barrel of oil produced, which measured the $200,000 contingent portion of the purchase price, is also unrelated to the value of the oil removed. In

other words, Petitioners were not entitled to an additional purchase price measured by the value of future oil produced but rather they were entitled to a specific payment to be made on a unit basis unrelated to value.

Thus, the opinion of the Tenth Circuit is not only in conflict with the Court of Appeals for the Eighth Circuit's decision in *Remer*, it is really inconsistent with its own criteria.

The cases cited above, including the Tenth Circuit opinions in *White* and *Pickard*, support the following factors as *indicia* of a sale, rather than a lease, in a mineral tax question:

1. Intention of the parties to make a sale. *Elbe.*

2. Absence of an obligation upon the purchaser to produce or develop the property. *Burton-Sutton* and *Remer.*

3. Total sales price stated. *White* noted that the absence of a total price (where the seller retains a royalty or a net profit interest over the life of the property) indicates a lease.

4. Payment to Seller unrelated to the value of the substance removed. *White.*

Petitioners' sale met all of the above criteria in that (i) the instrument of assignment recited and the Government stipulated that a sale was intended, (ii) the assignment did not impose upon Island Oil an obligation to produce or develop the properties, (iii) a total sales price of $700,000 was stated, and (iv) the deferred contingent payment was at a fixed amount ($1.25) per unit produced

without regard to the value of the unit. In summary, the deferred contingent payment was nothing more than a personal covenant of Island Oil, secured by the leases and equipment.

3. RESOLUTION OF THE ISSUE PRESENTED BY PETITIONERS' CASE IS OF CONTINUING IMPORTANCE TO THE STABILITY OF MINERAL TRANSACTIONS

Petitioners concede that if the Tax Reform Act of 1969 had been in effect in January of 1961 when Petitioners made their sale to Island Oil, no tax controversy would have resulted. Under the Tax Reform Act, a production payment retained on the sale of a mineral property is treated as a purchase money mortgage rather than an economic interest in the mineral property. Tax Reform Act of 1969, Pub. L. No. 91-172, Act Section 1503, amending Int. Rev. Code of 1954, Section 636(b). Therefore, it no longer makes any difference whether a retained interest is classified as a deferred payment of purchase price or a production payment. In either case, a sale results and capital gain is realized by the transferor on both the initial consideration and all subsequent payments.

However, the Tax Reform Act does not resolve or even deal with the problem of what constitutes an economic interest in minerals, which is the essential and underlying issue in this case. Notwithstanding the Tax Reform Act, the economic interest issue will still arise in mineral transactions, such as those illustrated by *Elbe, Burton-Sutton, White, Pickard* and *Remer,* where a transferor retains a right to a purchase price measured by a fixed price per unit of mineral extracted or a percentage of overall production

for the entire life of the property conveyed (e.g., royalty, net profits interest). Unless the Supreme Court grants certiorari in this case, taxation of the parties to these transactions will depend upon whether a taxpayer lives within the jurisdiction of the Eighth Circuit or Tenth Circuit as to whether such a transaction will be treated as a sale (capital gain to seller) or a sublease (ordinary income to seller).

Much confusion has resulted from the Court's attempting to distinguish between conveyances of oil and gas leases and conveyances of hard mineral interests. Even the Court of Appeals in *White* recognized the inconsistencies, concluding that ". . . there is no clear basis to distinguish hard mineral cases from the oil and gas cases." (401 F.2d at 614). It is submitted that the tax consequences of a transaction should not depend on the particular mineral extracted. Uniform rules of taxation should be formulated to guide all taxpayers engaged in the business of mineral extraction.

Petitioners submit that the issue presented here is an important question in the area of mineral taxation and its resolution by the Supreme Court will eliminate serious uncertainties presently existing. Petitioners respectfully re-

quest that the Court grant its Petition for Writ of Certiorari.

Respectfully submitted,

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February, 1971

APPENDIX A

FILED
United States Court of Appeals
Tenth Circuit
Oct. 5, 1970
HOWARD K. PHILLIPS
Clerk

UNITED STATES COURT OF APPEALS
TENTH CIRCUIT

SEPTEMBER TERM, 1970

K. E. and Z. M. McAFEE, Husband and Wife; JOHN W. and MARY D. NICHOLS, Husband and Wife; WILLIAM N. and HELEN K. LITTLE, Husband and Wife; LOUIS R. and INEZ P. WILSON, Husband and Wife; JOE F. and MARION G. GIBSON, Husband and Wife; and W. M. and MARY E. AVERY, Husband and Wife, Plaintiffs-Appellees, v. UNITED STATES OF AMERICA, Defendant-Appellant.	No. 105-70

Appeal from the United States District Court
for the Western District of Oklahoma
(D. C. No. 69-23)

Gary F. Fuller (John B. Dudley and McAfee, Dudley, Taft, Cates & Mark, of Counsel, on the brief) for Plaintiffs-Appellees.

Grant W. Wiprud, Attorney, Department of Justice (Johnnie M. Walters, Assistant Attorney General, and Lee A.

[APPENDIX]

Jackson, Attorney, Department of Justice, and William R. Burkett, United States Attorney, of Counsel, on the brief), for Defendant-Appellant.

Before JONES,* BREITENSTEIN, and HOLLOWAY, Circuit Judges.

BREITENSTEIN, Circuit Judge.

In an action for refund of federal income taxes, the district court held that a transaction relating to oil and gas leases was a sale with proceeds in issue taxable as capital gains. The United States appeals and contends that such proceeds are taxable as depletable ordinary income.

The facts are stipulated. The taxpayers owned undivided interests in oil and gas leases which they agreed to sell to Island Oil Company. They were to receive $180,000 in cash and a production payment of $320,000 payable, with interest, out of 80% of 3/4ths of all oil and gas produced, saved, and sold. Additionally, after Island recouped the $180,000 plus $320,000, together with costs of exploration and development, the taxpayers were to receive monthly sums equivalent to $1.25 per barrel for oil produced, saved, and sold until $200,000 had been paid. A vendors' lien on personal property was reserved to secure payment of the $200,000.

Island requested that Second Tarrant Foundation be allowed to participate. At the closing, attended by all parties, the taxpayers assigned the leases to Island and the production payment of $320,000 to Tarrant. In return they received $180,000 from Island and $320,000 from Tarrant. The assignment to Island did not contain an obligation to develop. Production has been sufficient to pay both the

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* Of the Fifth Circuit, sitting by designation.

$320,000 and the $200,000. The district court held that the assignments to Island and Tarrant were a single sale which covered all of the taxpayers' interest, that the assignment to Tarrant was not a sale of a carved-out oil payment on production, and that the deferred payments were a personal covenant or obligation of Island.

We are concerned with the tax treatment to be given the $320,000 paid by Tarrant to the taxpayers. The Supreme Court has developed the concept of a retained economic interest to determine whether proceeds from oil and gas transactions are taxable as depletable ordinary income or as capital gain. We considered those decisions in United States v. White, 10 Cir., 401 F.2d 610, and Commissioner of Internal Revenue v. Pickard, 10 Cir., 401 F.2d 615. No purpose would be served by retracing our steps. We recognized the retained economic interest rule and held that Helvering v. Elbe Oil Land Development Co., 303 U.S. 372, upon which the taxpayers rely, is limited to its particular facts. Pickard, supra, p. 616. We noted Commissioner of Internal Revenue v. Remer, 8 Cir., 260 F.2d 337, cited by the taxpayers, and declined to follow it. White, supra, p. 612. If the sum received by taxpayers from Tarrant is a carved-out oil payment resulting from the retention of an economic interest, the proceeds are taxable as depletable ordinary income. See Commissioner of Internal Revenue v. P. G. Lake, Inc., 356 U.S. 260. Cf. Wiseman v. Barby, 10 Cir., 380 F.2d 121, reversed 390 U.S. 339. The tax consequences of the transaction before us depend on whether the taxpayers retained an economic interest.

The taxpayers emphasize the terms of the Island assignment as proof that they intended, and made, but one sale. That instrument recites the intent of the taxpayers to sell all of their interest in the oil and gas "excepting only the production payment described in paragraph 2 [relating to the $320,000 payment] * * *," and recognizes the simultaneous sale of the production payment to Tarrant. It is true that the Island and Tarrant transactions occurred con-

temporaneously but, in our opinion, they do not constitute a single sale. Island and Tarrant did not join as co-purchasers of taxpayers leasehold interests. The reservation in the Island assignment of the $320,000 production payment created a new interest which the taxpayers transferred to a third party, Tarrant, by separate instrument. There were two transactions with unrelated parties and transfers of entirely different interests. The fact that both of the transactions were on the same day is immaterial .

The carve-out was by taxpayers, not by Island. The immediate payment of the $320,000 by Tarrant did not change this situation. The taxpayers simply sold to Tarrant their right to future income to be received from oil production. We have held that money paid to a taxpayer to reimburse him for the loss of future earnings is taxable as ordinary income. See Elliott v. United States, 10 Cir., — F.2d —.

The statement in the Island assignment that the taxpayers sold all of their interest in the oil and gas does not control. Actually, the taxpayers reserved an economic interest consisting of two production payments, one of $320,000 and one of $200,000. The simultaneous sale of the $320,000 payment did not divest the taxpayers of their entire interest. They still retained their right to the payment to be made subsequently. The argument that such payment was a personal covenant or obligation of Island is not persuasive. The instrument provides that the monthly payments shall be made "only as, if and when such oil is so produced," and that Island does not guarantee sufficient production to pay off the $200,000. This negates any idea of a personal covenant to pay the agreed sum. The measurement of the payments by a fixed sum per barrel does not change the situation. The payments are entirely dependent on production. The retention of the vendors' lien is immaterial. It secures the payments due from production and does not secure them without regard to production. We

have rejected the contention that absence of an obligation on the part of the assignee to develop indicates a sale. Commissioner of Internal Revenue v. Pickard, 10 Cir., 401 F.2d 615, 616. In our opinion the taxpayers retained an economic interest, and the proceeds from the sale to Tarrant of the carved-out oil production payment are taxable as depletable ordinary income.

Reversed.

APPENDIX B

IN THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF OKLAHOMA

K. E. McAfee, et al., Plaintiffs,	)	
vs.	)	No. CIVIL 69-23
United States of America, Defendant.	)	

JUDGMENT

The court having filed herein its findings of fact and conclusions of law and in pursuance thereof IT IS ORDERED, ADJUDGED AND DECREED as follows:

1. That the plaintiffs K. E. McAfee and Z. M. McAfee do have and recover judgment against the defendant for the sum of $6,809.84 with interest thereon as provided by law from November 4, 1966, and the further sum of $1,863.28 with interest thereon from the 10th day of April, 1967, and their costs.

2. That plaintiffs John W. and Mary D. Nichols do have and recover judgment against the defendant in the sum of $1,473.70 together with interest thereon from December 15, 1966, as provided by law and for the further sum

of $411.08 with interest thereon from December 15, 1966, as provided by law and costs of this action.

3. That plaintiffs William N. and Helen K. Little do have and recover judgment against the defendant in the sum of $641.80 with interest thereon from November 16, 1966, and the further sum of $176.70 with interest thereon from December 3, 1966, and costs of this action.

4. That plaintiffs Louis R. and Inez P. Wilson do have and recover judgment against the defendant in the sum of $869.66 with interest thereon from November 4, 1966, and the further sum of $238.10 with interest thereon from December 1, 1966, and costs of this action.

5. That plaintiffs Joe F. and Marion G. Gibson do have and recover judgment against the defendant in the amount of $703.44 with interest thereon as provided by law from the 4th day of November, 1966, and the further sum of $192.59 with interest thereon from December 5, 1966, and costs of this action.

6. That plaintiffs W. M. and Mary E. Avery do have and recover judgment against the defendant in the sum of $459.95 with interest thereon from the 10th day of November, 1966, and further judgment in the sum of $126.45 with interest thereon from December 28, 1966, and costs of this action.

Dated this 29th day of September, 1969.

s/ LUTHER BOHANON

UNITED STATES DISTRICT JUDGE
Western District of Oklahoma

IN THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF OKLAHOMA

K. E. McAfee, et al., Plaintiffs,	)	
vs.	)	NO. CIVIL 69-23
United States of America, Defendant.	)	

FINDINGS OF FACT AND CONCLUSIONS OF LAW

This cause having been submitted to the court on a stipulation of facts and agreed exhibits, and the court having fully considered the evidence as presented and arguments of counsel as set forth in their respective briefs, does make the following:

FINDINGS OF FACT

1. Prior to the 18th day of January, 1961, plaintiff K. E. McAfee, individually, and the other plaintiffs as general or limited partners of Jno. W. Nichols Exploration Co., Ltd., a limited partnership, along with others were the owners of an undivided interest in and to certain oil and gas leases located in Ector County, Texas.

2. Prior to said date plaintiffs had negotiated with Island Oil Company for the sale of all of their right, title and interest in and to said oil and gas leases and had agreed with the said Island Oil Company on a total purchase price of $700,000, to be paid $500,000 in cash at closing with a contingent additional payment of $200,000 as a personal obligation of the said Island Oil Company.

3. After the purchase price had been agreed upon, Island Oil Company requested that The Second Tarrant Foundation, Inc. be permitted to participate in the acquisition and pay a portion of the purchase price which plaintiffs agreed to.

4. Plaintiffs on the 18th day of January, 1961, executed and delivered assignments to Island Oil Company and The Second Tarrant Foundation at a single closing attended

by all parties at which time the sum of $500,000 in cash was received by the assignors.

5. The execution and delivery of the assignments by plaintiffs on January 18, 1961, was intended by the parties, and was in fact, a single sale of all of plaintiffs' right, title and interest in and to the oil and gas leases and the assignments executed and delivered on said date fully and completely divested plaintiffs of all of their right, title and interest in and to the oil and gas leases and production therefrom and they thereafter had no economic interest therein.

6. The assignment to The Second Tarrant Foundation on January 18, 1961, was not in substance or fact the assignment or sale of a carved out production payment or oil payment.

7. The deferred payments called for by the assignment to Island Oil Company was intended to be, and in fact and substance was, a personal covenant or obligation of Island Oil Company, and plaintiffs did not thereby retain any economic interest in and to the oil and gas leases or production therefrom.

8. Island Oil Company was not obligated to produce or further develop the leases.

9. During the negotiations for the sale of the properties, the parties had engineering data indicating sufficient reserves to meet the conditions precedent to Island Oil Company's obligation to pay the additional $200,000 contingent portion of the purchase price and this subsequently proved to be the case as the plaintiffs have received all consideration that they bargained for in the sale.

10. That each of the plaintiffs paid the additional tax and interest assessed by defendant under protest, that each of them made timely claims for refund and instituted this action within the time prescribed by statute and the computation and amounts sued for by plaintiffs as set forth in the complaint, and the amendment thereto, are true and correct.

CONCLUSIONS OF LAW

1. The assignment executed by plaintiffs on January 18, 1961, to The Second Tarrant Foundation did not constitute the sale of a carved out oil payment or production payment.

2. The contingent deferred portion of the purchase price to be paid by Island Oil Company constituted nothing more than a personal covenant or personal obligation of Island Oil Company.

3. The assignments dated January 18, 1961, executed by plaintiffs to Island Oil Company and The Second Tarrant Foundation constituted a single sale which covered all of plaintiff's right, title and interest in and to the oil and gas leases referred to and covered thereby and plaintiffs thereafter had no economic interest in and to said leases or production therefrom.

4. Plaintiffs are entitled to judgments for the amounts sued for, together with interest thereon as provided by law.

Dated this 29th day of September, 1969.

s/ LUTHER BOHANON

UNITED STATES DISTRICT JUDGE
Western District of Oklahoma

In the Supreme Court of the United States

OCTOBER TERM, 1970

No. 1294

K. E. AND Z. M. MCAFEE, HUSBAND AND WIFE, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The findings of fact and conclusions of law of the district court (Pet. App. vii–ix) and the opinion of the court of appeals (Pet. App. i–v) are not yet reported.

JURISDICTION

The judgment of the court of appeals was entered on October 5, 1970. By order dated January 4, 1971, Mr. Justice White extended the time for filing a petition for a writ of certiorari to and including February 2, 1971. The petition was filed on February 2, 1971. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether petitioners reserved two production payments from an assignment of their interest in oil and gas leases, so that the assignment of one of the two production payments to a third party yielded depletable ordinary income rather than capital gain.

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of the Internal Revenue Code of 1954 and Treasury Regulations thereunder are set forth in the petition (pp. 3–4).

STATEMENT

Petitioner K. E. McAfee, individually, and some of the remaining petitioners,[1] as members of two partnerships, owned an undivided interest in certain oil and gas leases. They agreed to assign their interest to Island Oil Company for $700,000, with The Second Tarrant Foundation participating and paying a portion of the price. On January 18, 1961, petitioners executed an assignment to Island Oil for the following considerations: (1) $180,000 in cash; (2) a reserved production payment of $320,000, payable with interest out of 80 percent of ¾th of all oil and gas produced, saved and sold; and (3) additional payments of $200,000 payable (after Island Oil had recouped the $180,000 cash and the $320,000 production payment plus costs of exploration and development) at the rate of $1.25 per barrel for oil produced, saved and sold, and secured by a vendor's lien on Island Oil's equip-

[1] The other petitioners are parties hereto only because they filed joint income tax returns with their spouses.

ment and personal property. At the closing, petitioners assigned the reserved $320,000 production payment to Tarrant for $320,000 in cash. (Pet. App. ii, vii–viii.)

Island Oil was not obligated under the assignment to develop the leases. Nor did it guarantee sufficient production to pay off the $200,000; the assignment provided that the per barrel payments should be made "only as, if and when" oil was produced. However, engineering studies available to the parties during their negotiations indicated that there were sufficient reserves to pay the $200,000 in full, and petitioners have in fact received this sum in per barrel payments. (Pet. App. ii–iv, viii.)

The district court held that the per barrel payments were nothing more than a personal obligation of Island Oil, and that petitioners had effected a single, outright sale of their interest in the oil and gas leases to Island Oil and Tarrant for $700,000. Accordingly, since in the court's view petitioners had retained no economic interest in the leases, they were entitled to report the $320,000 received from Tarrant as capital gain. (Pet. App. vii–ix.)

On appeal, the Tenth Circuit reversed. It recognized, first, that Island Oil and Tarrant were not co-purchasers, but rather that the reservation of the $320,000 production payment created a new interest which petitioners transferred to Tarrant by separate instrument. It also held that the $200,000 in per barrel payments constituted a second retained production payment, since, under the terms of the assignment, the payments were to be made "only as, if and when"

oil was produced.[2] The court concluded that petitioners had retained an economic interest in the leases, in the form of the two production payments, that they simply sold to Tarrant the right to receive future income from oil production, and consequently that the proceeds of the sale of the carved-out production payment were taxable as ordinary income, subject to depletion. (Pet. App. i–v.)

ARGUMENT

The decision below is correct. There is no conflict or other basis for further review.

1. An assignment of mineral rights by a taxpayer who retains an economic interest in the mineral property yields depletable ordinary income, not capital gain. *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U.S. 25. Such an interest was defined in *Palmer* v. *Bender*, 287 U.S. 551, in terms of the two requirements which are now set forth in Section 1.611–1(b)(1) of the Treasury Regulations, as follows:

> An economic interest is possessed in every case in which the taxpayer [1] has acquired by investment any interest in mineral in place * * * and [2] secures, by any form of legal relationship, income derived from the extraction of the mineral * * * to which he must look for a return of his capital.

"The second factor has been interpreted to mean that the taxpayer must look *solely* to the extraction of oil or gas for a return of his capital * * *." *Com-*

[2] The court observed (Pet. App. iv) that the vendor's lien retained by petitioners did not guarantee the $200,000 payout, but merely secured the per barrel payments that would become due by reason of production.

missioner v. *Southwest Expl. Co.*, 350 U.S. 308, 314.

It is settled that the reservation of a production payment by a transferor of mineral rights constitutes the retention of a depletable economic interest. *Thomas* v. *Perkins*, 301 U.S. 655; *Anderson* v. *Helvering*, 310 U.S. 404, 409–411; *Burton-Sutton Oil Co.* v. *Commissioner*, *supra*, 328 U.S. at 36. It is likewise settled that a production payment is "a specified sum of money, payable out of a specified percentage of the oil, or the proceeds received from the sale of such oil, if, as and when produced * * *." *Anderson* v. *Helvering*, *supra* at 410. Thus, in *Thomas* v. *Perkins*, *supra* at 657, the Court held that a reserved production payment which was "payable out of oil only, if, as and when produced" was a retained economic interest. And, in discussing this ruling with approval in *Anderson* v. *Helvering*, *supra* at 411, the Court noted that "[t]he decision did not turn upon the particular instrument involved, or upon the formalities of the conveyancer's art, but rested upon the practical consequences of the provision for payments of that type."

The court of appeals correctly applied the foregoing principles in the instant case. Like the interests involved in *Anderson* v. *Helvering*, *supra*, and *Thomas* v. *Perkins*, *supra*, petitioners' per barrel payments were to be made only if, as and when oil was produced. The right to receive payments thus was dependent solely on production, and constituted an economic interest under this Court's decisions and the pertinent Treasury Regulations. That receipt of the payments was reasonably assured based on engi-

neering studies does not help petitioners' case. On the contrary, this Court has twice held, most recently summarily, that whenever a production payment is carved out or created, and particularly where the payout is assured in advance, a sale of the payment yields depletable ordinary income. *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260; *Wiseman* v. *Barby*, 390 U.S. 339, reversing 380 F. 2d 121 (C.A. 10).

2. Petitioners concede (Pet. 19) that the precise issue raised here has been resolved for the future by Section 636 of the Code, as amended by the Tax Reform Act of 1969, P.L. 91–172, 83 Stat. 630. This, without more, makes the instant case an inappropriate one for the resolution of any conflict that might exist. But there is, in any event, no such conflict.

a. Petitioners assert conflict with *Helvering* v. *Elbe Oil Land Co.*, 303 U.S. 372, contending that under that decision they effected a sale of their entire leasehold interest because there was no obligation on the part of Island Oil to develop the leases, and because they intended to effect a sale (Pet. 9–15). This contention is without merit.

In *Elbe Oil*, there was an assignment of an oil and gas lease for $2,000,000 (of which $350,000 was to be paid at the outset and the balance in four annual installments) plus one-third of the net profits after the transferee was reimbursed for its expenditures in the acquisition, development and operation of the properties. The Court held that the transaction was a sale notwithstanding the retention of a net profits interest. The Court did not appear to attach any particular significance to the absence of an obligation

on the part of the transferee to develop the properties; it referred only to the fact (303 U.S. at 375) that the transferor "did not retain any interest or investment" in the properties.

Thereafter, in *Burton-Sutton Oil Co.* v. *Commissioner, supra,* the Court held that a reserved net profits interest constituted a retained economic interest, so that an assignment of mineral rights was not a capital transaction. In so holding, the Court noted in passing that the agreement before it required the transferee to develop the property, whereas the agreement in *Elbe Oil* contained no such requirement. But the Court stated the primary ground for distinguishing *Elbe Oil* as follows (328 U.S. at 36):

> The issue upon which this Court passed [in *Elbe Oil*] was the classification of the deferred payments. * * * These deferred payments were not payable out of oil sales but were payable absolutely, unless there was an abandonment. This Court concluded that the addition of a provision for the payment of a share of net profits did not qualify "in any way the effect of the transaction as an absolute sale." * * * In view of what we have said in this and in the *Kirby Petroleum* case as to the economic interest in the oil of a recipient of a share of the net profits, *the holding of Elbe should not be extended to the facts of this agreement.* [Emphasis supplied.]

Obviously, in *Burton-Sutton* the Court was concerned with limiting the import of *Elbe Oil.* To this end, it distinguished *Elbe Oil,* principally as a case involving large deferred payments in fixed amounts.

Burton-Sutton did not establish any general principle that a transfer of a mineral interest, with an economic interest retained, is a capital transaction if the transferee is not required to develop the property, or if the instrument of assignment is couched as a sale. To the contrary, it recognized without qualification that (328 U.S. at 36)—

> we have construed an assignment of oil leases for cash and a deferred payment, "payable out of oil only, if, as and when produced," as the reservation of an economic interest in the oil—not a sale. *Thomas* v. *Perkins,* 301 U.S. 655.

The form of the instrument is immaterial. *Burton-Sutton Oil Co.* v. *Commissioner, supra,* at 32. As the Court explained in *Palmer* v. *Bender, supra,* 287 U.S. at 555–556, "[t]he formal attributes of those instruments or the descriptive terminology which may be applied to them in the local law are both irrelevant."[3]

Furthermore, *Elbe Oil* did not involve, as does the case at bar, the carve-out and sale of a production payment on which the payout is assured. That aspect of the instant case brings into play *P. G. Lake* and *Wiseman* v. *Barby, supra,* and those decisions require

[3] Recent appellate decisions dealing with the question whether a transfer of mineral rights is a capital transaction have not turned on the "intent" of the parties or the presence or absence of an obligation to develop on the part of the transferee, but solely upon whether or not an economic interest was retained. See, *e.g.*, *Oliver* v. *United States*, 408 F. 2d 769 (C.A. 4); *Hair* v. *Commissioner*, 396 F. 2d 6 (C.A. 9); *Wood* v. *United States*, 377 F. 2d 300 (C.A. 5), certiorari denied, 389 U.S. 977; *Rabiner* v. *Bacon*, 373 F. 2d 537 (C.A. 8); *United States* v. *White*, 401 F. 2d 610 (C.A. 10); *Commissioner* v. *Pickard*, 401 F. 2d 615 (C.A. 10); *Schreiber* v. *United States*, 382 F. 2d 553 (C.A. 7).

that the proceeds of the sale to Tarrant be treated as depletable ordinary income, not capital gain.

b. Likewise without merit is petitioner's claim (Pet. 16–19) that the decision below conflicts with the law of the Eighth Circuit as reflected in *Commissioner* v. *Remer,* 260 F. 2d 337. *Remer* was unusual in that it involved iron ore already extracted from the ground and stockpiled, rather than minerals in place. Moreover, it has been limited to its particular facts by the Eighth Circuit's subsequent decision in *Rabiner* v. *Bacon,* 373 F. 2d 537. In that case, the court held, following *Palmer* v. *Bender, supra,* and cognate decisions, that the proceeds of a transfer of mineral rights was depletable ordinary income because—without regard to the "intent" of the parties or an obligation on the part of the transferee to develop the property—the transferor remained dependent upon production and thus retained an economic interest. Contrary to petitioners' assertion (Pet. 20), therefore, the instant case would be decided the same way by the Eighth Circuit as it was by the court below.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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